RULE 146: THE PRIVATE OFFERING EXEMPTION—HISTORICAL PERSPECTIVE AND ANALYSIS

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I. THE HISTORICAL PERSPECTIVE

As a reaction to the speculative abuses of the '20s, Congress enacted the Securities Act of 1933[1] to regulate the distribution of securities in interstate commerce. The scheme of the Act was to provide for the registration of all securities prior to distribution with certain exceptions carved out. One of these exceptions was for "transactions by an issuer not involving a public offering."[2] The Act does not contain a definition of the term "public offering." A reference to legislative reports provides little guidance for the exegesis of the exemption. The House Report on

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1 15 U.S.C. § 77a *et seq.* (1970) (hereinafter cited as the Act).

2 Securities Act of 1933, § 4(2), 15 U.S.C. § 77d (1970). This provision appeared as § 4(1) of the Act but was renumbered § 4(2) by the Securities Act Amendments of 1964. Pub. L. No. 88-467, §12, 78 Stat. 565, 580, amending 15 U.S.C. §77d(1) (1958). The bill originally introduced in the House of Representatives (H.R. 4314 by Mr. Rayburn, March 29, 1933) in §12(c) exempted:

> Isolated transactions in which any security is sold, offered for sale, subscription, or delivery by the owner thereof, or by his representative solely for the owner's account, such sale or offer for sale, subscription, or delivery not being made in the course of repeated and successive transactions of a like character by such owner for the purpose of engaging in the purchase and sale of securities as a business, and such owner or representative not being the underwriter of such security.

Mr. Rayburn introduced H.R. 5480 on May 3, 1933, which contained substantially all of the provisions of the Act as enacted. As introduced, the cognate provision of §4(1) exempted "transactions by an issuer not with or through an underwriter." In the House debates, Mr. Rayburn added a Committee Amendment: the words ". . . and not involving any public offering," were added after the word "underwriter." This was termed a "clarifying amendment." 7 Cong. Rec. 2910 at 2954 (1933). The bill was passed with Section 4(1) in this form.

The Senate had before it S.R. 875, introduced by Mr. Robinson on March 29, 1933, which was substantially the same as H.R. 4314, and retained the same form when passed by the Senate as an amendment to H.R. 5480 on May 8, 1933. Section 12(c) of S.R. 875 as passed by the Senate exempted only isolated transactions in ". . . securit[ies] issued subsequent to the date of approval . . ." of the Act.

A conference committee was appointed May 9, 1933, which recommended the Act as enacted, substantially in the form of H.R. 5480, and without change to Section 4(1) as set forth above. The committee did not comment on the resolution of the differences between Section 4(1) and Section 12(c) of S.R. 875. The House on May 22, 1933, and the Senate on May 23, 1933, agreed to the report and it was approved on May 27, 1933.

The phrase ". . . not with or through an underwriter" was deleted in §203(a) of the Securities and Exchange Act of 1934, 15 U.S.C. §§78a *et seq.* (1970) (hereinafter referred to as the Exchange Act). This was regarded as "really superfluous." H.R. Rep 1838, 73rd Cong. 2d. Sess. 41. The complete legislative history of the Act and the Exchange Act can be found in J. S. ELLENBERGER AND E. P. MAHAN, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 (1973).

the Act indicates that the registration requirement of § 5[3] is intended to provide "full and fair disclosure" with respect to new offerings of securities.[4] This should be read in conjunction with another phrase from the House Report which states that the Act

> carefully exempts from its application certain types of securities and securities transactions where there is not practical need for its application or where the public benefits are too remote.[5]

With particular reference to § 4(1), the Report indicates that the exemption is available "to permit an issuer to make a specific or isolated sale of its securities to a particular person" but is not available for sales "made generally to the public."[6]

The importance of exemption from registration can be best understood when one considers the expense, difficulty, and time consumed by registration under the provisions of the Act. A registration of securities under the Act ordinarily will require the services of lawyers, accountants, and printers, and possibly other expert services. Depending upon the number of times that a particular issuer has registered securities, the size of the issue, and the novelty or complexity of problems that may be involved in the registration process, costs may range from $35,000 to $100,000 or perhaps higher—even without considering underwriters dis-

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3 Sec. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments or transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

For a discussion of the registration requirements, see C. ISRAELS AND G. DUFF, WHEN CORPORATIONS GO PUBLIC (1962).

4 H.R. REP. 73rd Cong. 1st Sess. 1 (1933) (hereinafter cited as House Report).

5 House Report, *supra* note 4, at 5.

6 House Report, *supra* note 4, at 16.

counts and commissions, which may be as high as fifteen percent.[7] Unless the issue is fortunate enough to receive cursory review (an expedited procedure normally reserved for issues after the first one),[8] two to three months' time for review by the staff of the Securities and Exchange Commission (SEC) is not unusual. In comparison, a private placement requires no filing with or review by the SEC and much smaller underwriting commissions.[9]

Prior to 1953, the legal constraints of the private placement exemption received little attention. An early SEC Release[10] stated that the factors to be considered in determining the applicability of § 4(2) of the Act were:

1. The number of offerees and their relationship to each other and to the issuer;
2. The number of units offered;
3. The size of the offering; and
4. The manner of the offering.

In applying this section prior to 1953, courts typically examined all of the facts surrounding a sale, and on the basis of this factual inquiry, determined whether a transaction constituted a "public offering" requiring registration or qualified for the § 4(2) exemption.[11]

As a practical matter, both the staff of the SEC and the practicing bar tended to focus on the question of the number of offerees. In the same Release, the General Counsel's Office expressed the view that an offering to "an insubstantial number of persons" would not constitute a public offering. A rule of thumb was suggested to the effect that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and prob-

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[7] In the recent offering by Kenai Drilling Limited of units consisting of one common share and two warrants, at $4.50 per unit, the issuer paid underwriters discounts of $234,406 and paid all of its filing, printing, legal, accounting and miscellaneous expenses amounting to approximately $140,000. The issuer thus received approximately $1,538,094 out of total proceeds of $1,912,500, or approximately 79.7%. In addition, the underwriter received a 30-day option to purchase additional units to cover over-allotments which could have provided the underwriter with an additional $17,691; the underwriter received preferential financing rights, a three-year warrant for 42,500 shares of common stock similar to the warrant sold as part of the unit, a three year "financial consulting arrangement" at $6,000 per year and indemnification rights.

[8] 33 FED. REG. 17900; Securities Act Release No. 33-4934.

[9] State "Blue Sky" laws may require registration. *See, e.g.*, OHIO REV. CODE ANN. § 1707.06 (Page 1964).

[10] 11 FED. REG. 10952 (1935) (hereinafter cited as Release 285).

[11] *See, e.g.*, SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938) (offer to 530 stockholders held a public offering).

ably does not involve a public offering."[12] In this connection, one authority has noted:

> As a practical matter this is the test which many lawyers have used to mark the zone of danger. Offers to twenty-five persons are regarded as safe; if more than that are involved, there must be other factors justifying the larger number.[13]

In *Securities & Exchange Commission v. Ralston Purina Co.*,[14] the United States Supreme Court changed this approach. Ralston Purina was a large public corporation. At the time of the case, it had approximately 7,000 employees. Beginning in 1911, the company encouraged stock ownership among its employees. Between 1947 and 1951, Ralston Purina sold nearly $2,000,000 of its common stock to its employees in reliance upon the private offering exemption. According to the opinion:

> Among those responding to these offers [for sale of Ralston Purina stock] were employees with duties of the artist, bake-shop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill office clerk, order credit trainee, production trainee, stenographer and veterinarian.[15]

The buyers were dispersed throughout the country. The lowest salary bracket of those purchasing during the four years in question was $2,435.00. During the period in question, between 400 and 1,100 persons purchased stock under the program. It was estimated that offers were made to 500 employees in 1951, when the program was discontinued because of litigation.

While conceding that an offering to *all* its employees would be a public offering not within the scope of the exemption, the company contended that all employees who purchased were "key employees." The Court found that the sale of stock by Ralston Purina was not entitled to the private placement exemption. This holding surprised no one as it certainly was in the mainstream of the interpretation of the statute at that time. Unfortunately, as so often happens in law, it was not the holding of the Court but the dicta that sowed the seed of future uncertainty. Thus, the Court said:

> The exemption as we construe it, does not deprive corporate employees, as a class, of the safeguards of the Act. We agree that some employee offerings may come within § 4(1), e.g., one made to executive

[12] Release 285, *supra* note 10.

[13] R. JENNINGS AND H. MARSH, SECURITIES REGULATION, CASES AND MATERIALS (3d ed. 1973) at 408 (hereinafter cited as JENNINGS AND MARSH).

[14] 346 U.S. 119 (1953).

[15] 346 U.S. at 121.

> personnel who because of their position have access to the same kind of information that the Act would make available in the form of a registration statement. Absent such a showing of special circumstances, employees are just as much members of the investing 'public' as any of their neighbors in the community.[16]

Each of these sentences taken separately is unexceptional. Strung together, they have led some commentators to believe that a private offering could only be made to a group of persons who had some special "access" to the issuer, such as directors and executive personnel.

The SEC asked the Court to hold that "an offering to a substantial number of the public" is not exempt, but the Court went on to say

> We are advised that 'whatever the special circumstances, the Commission had consistently interpreted the exemption as being inapplicable when a large number of offerees is involved.' *But the statute would seem to apply to a 'public offering' whether to few or many.*[17]

When this additional ingredient was mixed in the stew, it became an unpalatable diet for issuers. No longer was there any safety in numbers. Now, an offering to a single person could theoretically be "public," although in some cases, offerings to nearly 100 institutional investors were held to be private.[18]

There was other dicta in *Ralston Purina* that contributed to the ensuing confusion with respect to the private offering exemption. The Court said:

> The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which 'there is no practical need for [the bill's] application,' the applicability of §4(1) [now § 4(2)] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'[19]

It became the SEC staff position to inquire whether there was evidence that the offerees could "fend for themselves."[20] Read literally, that interpretation can be made; but if we look at the facts of the case and the number of persons involved, we realize that the Court was focusing upon the peculiar circumstances set forth in the opinion. Note that in the original House Report on the Securities Act of 1933 two reasons were given for the private placement exemption. First, "where there was no

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16 346 U.S. at 125-6 (Footnotes excluded).

17 346 U.S. at 125 (Emphasis added).

18 JENNINGS AND MARSH, *supra* note 13, at 409.

19 346 U.S. at 124.

20 *See, e.g.,* Rule 146 Release, *infra* note 46.

practical need for [the bill's] application," and secondly, "where the public benefits are too remote." The Court did not refer to the second reason in its opinion because it was not involved in the facts of the particular case. If the number of stockholders had been reduced by ninety percent, the latter rationale might well have been a basis for affirming the exemption.

After *Ralston Purina*, the word "access" became a term of art. The highwater mark of this school of thought was the Fifth Circuit's decision in *Securities & Exchange Commission v. Continental Tobacco, Inc.*,[21] which threw the securities bar into chaos with respect to opinions on the availability of the private placement exemption. The position of the SEC in its brief on appeal was the exacerbating factor.[22]

Continental Tobacco developed a new product, Venture cigarettes, which were supposedly low in carcinogens. In 1967, the company made various offerings of securities without registration under the Act which resulted in the entry in the district court of an injunction against further violations. In 1968, the company was reorganized under the provisions of Chapter 11 of the Bankruptcy Act.[23] Beginning in the spring of 1969 and ending in the fall of 1970, new management attempted to refinance the company through the sale of 200,000 shares of common stock at $1.00 a share. Very careful preparations were attempted in order to comply with § 4(2) of the Act. As the court noted:

> Prior to the planned offering and attempted sale of its common stock to prospective purchasers, Continental apparently sought to lay the foundation for an exemption of such common stock from the registration provisions of the Securities Act of 1933. First, it had prepared a brochure on its prospects, including unaudited financial statements for the period ending May 15, 1969. As Continental's circumstances changed, the brochure was updated in the months of February and June of 1970, and the unaudited financial statements were updated to the period ending December 31, 1969. The front cover of the brochure carried the following legend:
>
> The shares offered in this Private Replacement [sic] had not been registered with the Securities and Exchange Commission under the Securities Act of 1933, as amended, and are offered under a specific exemption which depends upon the Investment Intent of the Purchasers of these shares.
>
> Secondly, Continental had a standard *Subscription Agreement and Investment Letter* prepared. It was contemplated that the *Subscription*

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21 463 F.2d 137 (5th Cir. 1972).

22 *See* notes 40-41, *infra* and accompanying text.

23 11 U.S.C. §§701 *et seq.* (1970).

Agreement and Investment Letter would be executed by all investors in the common stock of Continental.[24]

Lastly, Continental stamped on each certificate of its common stock a red legend reading as follows:

> These securities may not be sold, transferred, pledged, or hypothecated unless they have first been registered under the Securities Act of 1933 or unless counsel satisfactory to the Company has given an opinion that registration under said Act or applicable blue sky laws is not required.

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[24] The following is the text of the Subscription Agreement and Investment Letter:

Continental Tobacco Company
of South Carolina, Inc.
Columbia, South Carolina
Gentlemen:

I hereby subscribe to ——— shares of your company's unregistered common stock at a price of $1.00 per share for an aggregate of $———.

In connection with the purchase by me of shares of your common stock, I hereby represent to you that such are being acquired for investment and not with a view to, or for resale in connection with, any distribution of such shares.

By such representation I mean that I intend to hold such shares for investment for my own account, and that I do not intend to dispose of all or any part of such shares unless, and until, I determine that some change in my personal circumstances, by reason of some intervening event not now in contemplation, has occurred which makes such disposition necessary.

I understand that the shares being issued to me have not been registered under the Securities Act of 1933, as amended, by reason of a specific exemption under the provision of the Act which depends upon my investment intent. In this connection, I understand that in the view of the Securities and Exchange Commission the statutory basis for such exemption would not be present if my representation merely meant that my present intention was to hold such stock for the six months' capital gains period of the tax statutes, for a deferred sale, for a market rise, for a sale if the market does not rise, or for a year or other fixed period in the future. I realize that in the view of the Commission a purchase now with an intent to resell by reason of any foreseeable specific contingency or an anticipated change in market values, or in your condition or that of the industry, or in connection with a contemplated liquidation or settlement of any loan obtained by me for the acquisition of such shares and for which such shares were pledged for security, would represent a purchase with an intent inconsistent with my representation to you, and the Commission might regard such a sale or disposition as a deferred sale as to which the exemption is not available.

I understand the nature of the investment being made and the financial risks thereof. I have received a copy of your written prospectus including unaudited financial statements as of May 15, 1969 by Clarkson, Harden & Gantt, Certified Public Accountants. I have read and reviewed same and I have questioned the officers of the company and counsel for the company concerning the business and financial statements of the company and have been offered access to any and all records of the company and I do not desire any further information or data concerning your company.

I consent that you may, if you so desire, permit the transfer of the shares referred to herein out of my name only when my request for transfer is accompanied by either an opinion of counsel to the effect that neither the sale nor the proposed [sic] results is a violation of the Securities Act of 1933, as amended, or a no-action letter from the Commission with respect to the proposed transfer. I agree that a legend to this effect may be placed on the certificate or certificates delivered to me or any substitute therefor.

Very truly yours,

———————

463 F.2d at 146, n.1.

> Meetings were held by the Tews [management] with prospective purchasers, through the help of friends and contacts in the legal profession and the broker-dealer business, and through the support of investors. The record is replete with testimony describing, illustrating, and explaining each of these aids to the 1969-1970 offering of the common stock of Continental.[25]

The trial court[26] found facts supporting the exemption. As was noted by the appellate court:

> Apparently, the District Court arrived at this conclusion by finding that "from approximately June, 1969, until October, 1970, the defendant, Continental, offered common stock to thirty-eight persons, of which it sold common stock to thirty-five persons"; that "almost all of these investors executed an agreement with the defendant corporation prior to the purchase of their common stock ("investment letters") which acknowledge receipt of a brochure concerning the corporation and which included unaudited financial statements"; that "the testimony of the common stock purchasers of Continental, who were called as witnesses by the plaintiff, established that these investors had received both written and oral information concerning the corporation, that they had access to any additional information which they might have required or requested, that they had personal contacts with the officers of the defendant corporation"; that "these witnesses further testified that they knew the risk of their investments, that they knew the stock was not registered, and that they had purchased the stock with the intent to hold the stock for investment and not to resell it"; that "the evidence also showed that the stock has remained in the hands of the original purchasers and that the defendant, Continental, had refused to allow transfer of this unregistered stock"; and that "the experience and background of these investors were such that they were in a position to make an informed investment decision, i.e., they could fend for themselves.
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> Furthermore, the Court found that the persons who were offered common stock, options to purchase common stock, and promissory notes by the defendant corporation were furnished and/or provided access to the same type and kind of information that would have otherwise been provided in a registration statement filed pursuant to the Securities Act of 1933, as amended, and rules and regulations thereunder.[27]

The SEC in its brief on appeal disputed most vigorously the district court's findings of access.

> The required relationship must be such that the offeree has *access* to corporate information—not because he has been the gratuitous recipi-

[25] 463 F.2d at 146.

[26] 326 F. Supp. 558 (S.D. Fla. 1971).

[27] 463 F.2d at 157. It is difficult to reconcile the district court's finding of thirty-eight purchasers, apparently accepted by the appellate court, with the interrogatory cited in the opinion (463 F.2d at 154) showing twenty-eight purchasers, including Tew, the president of the company and two others who received stock pursuant to the Chapter 11 proceedings.

> ent of a promotional circular about an unfamiliar company, but because his position or connection with the company enables him to demand and receive first hand on all relevant facts . . . in other words, . . . each offeree [has] a relationship to the company tantamount to that of an 'insider' in terms of his ability to know, to understand and to verify for himself all of the relevant facts about the company and its securities.[28]

The court of appeals reversed the district court's judgment and remanded for appropriate injunctive relief. In an opinion that may serve as a model for arcane obscurity in the securities field, the court found two basic reasons for denying the exemption. The first was:

> The record does not establish that each offeree had a relationship with Continental giving access to the kind of information that registration would have disclosed.[29]

Note at this point how the word "access" has developed. In *Ralston Purina*, the Supreme Court indicated that perhaps an offering to a large number of employees would still be a private offering if they were executive personnel who, because of their position, would have "access to the same kind of information that the Act would make available in the form of a registration statement."[30] In *Continental Tobacco*, the court of appeals makes "access" the touchstone regardless of the numbers involved. The appellate court went on in discussing this point to say that "some of the purchasers had never met any officers of the company prior to acquiring the stock."[31] The court evidently overlooked the fact that private placements develop principally as a method of distribution to institutional investors through investment bankers, and that these institutional investors customarily did not meet with officers of the company.[32]

The second reason for the holding against the exemption was that the evidence of the number of actual offerees (not purchasers) was insufficient. The court reached this conclusion despite the finding of the district court that there were only thirty-eight offerees.[33] The court then noted that

> Continental failed to sustain its burden of proving there existed no practical need for the application of Section 5 of the Securities Act of 1933 to its 1969-1970 offering of securities. Neither did it prove that the public benefits to be derived from registration were too remote.[34]

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28 Brief for Appellant 26, 28.

29 463 F.2d at 158.

30 346 U.S. at 125-6.

31 463 F.2d at 158.

32 *See* C. WHITMAN, *Private Placements and Rule 146* in THE SEC SPEAKS AGAIN 132 (1973) (hereinafter cited as WHITMAN).

33 *See* note 27, *supra.*

34 463 F.2d at 160.

Two comments are in order about the opinion. First, there is probably a technical but harsh ground for finding against Continental. This is based upon the court's statement that "the evidence shows that neither Theodore King nor T. M. Alexander ever had access to one of Continental's prospectuses . . . ."[35] The other comment is that the opinion was based upon the application of a heavy burden of proof to the party claiming the exemption. There is substantial judicial support for this burden.[36] It has been said that proof must be "explicit, exact and not built on conclusory statements."[37] But, it might be well to stop a minute and speculate as to what public purpose is served by imposing such a heavy burden upon one claiming an exemption from the registration process. As was previously noted,[38] registration is expensive, time consuming, and for many young companies, impossible within their resources. Public policy is both served by protecting investors through the registration process and encouraging growth of young developing companies. *Continental Tobacco* might present an interesting application of this theory. This company was engaged in the production of a cigarette that was purportedly low in carcinogens and thus less likely to produce cancer. Coming out of a bankruptcy reorganization, it may have found registration impossible. At no time did the SEC claim that Continental's disclosure document was other than a complete and fair presentation of the facts relating to the company. Isn't public policy better served by a balancing of the needs of growing companies for venture capital against the needs of investors for protection? With this kind of a standard, the court of appeals would have had substantial difficulties in overturning the very clear findings of the district court based on the facts described above.[39]

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35 *Id.*

36 SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Hill York Corp., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971); Chapman v. Dunn, 414 F.2d 1531 (6th Cir. 1969); United States v. Custer Channel Wing Corp., 367 F.2d 675 (4th Cir. 1967), *cert. denied*, 389 U.S. 850 (1967); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699 (9th Cir. 1938).

In *Ralston Purina*, the Court cited as its authority for this proposition the case of Schlemmer v. Buffalo, Rochester and Pittsburgh Ry., 205 U.S. 1 (1907). In that case, plaintiff's decedent was killed while trying to couple a steam shovel to a train. The steam shovel did not have an automatic coupling device required by the Safety Appliance Act of 1893. On appeal, defendant attempted to argue that plaintiff had not shown the proviso to be inapplicable. Mr. Justice Holmes for the Court stated that the proviso carves certain cases out of the statute and that the burden of proof followed the rule of construction, so that defendant would have to show that it fell within the proviso. The rule of construction that exceptions to remedial statutes are strictly construed is ancient. *See, e.g.*, J. SUTHERLAND, STATUTORY CONSTRUCTION (1st ed. 1883).

37 Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971).

38 *See* notes 7-9 and accompanying text.

39 *See* text accompanying notes 24-28.

Much of the result of *Continental Tobacco* was induced by the brief of the SEC. Former SEC Commissioner Owens characterized the SEC's brief as overly restrictive,[40] and it has been suggested on various occasions that the decision of the court of appeals resulted from the position of the SEC's staff.[41] If the SEC's position were to be taken literally, private placements could only be made to highest executive officers and directors of a corporation.

II. Rule 146

A. *Preliminary Matters Concerning The Rule*

The SEC initially proposed Rule 146 in November 1972,[42] and after receiving many comments,[43] released for comment a second draft.[44] After again receiving numerous comments, the SEC adopted a third version on April 23, 1974.[45] The text of the Rule is set forth in full in the appendix to this article.

What has been designated as Rule 146 under the Securities Act of 1933 is entitled "Transactions by an Issuer Deemed Not to Involve Any Public Offering." The Rule was adopted pursuant both to §§ 4(2) and 19(a) of the Act.[46] Section 19(a) gives the SEC the power to make

> such rules and regulations as may be necessary to carry out the provisions of this title, . . . and defining accounting, technical and trade terms used in this title.[47]

Thus, Rule 146 is a definition of transactions by an issuer not involving any public offering.

The Rule was accompanied by a release which includes a general discussion of the history of the private placement exemption prior to the adoption of the Rule and continues the exegesis of the word "access":

> [It] is frequently asserted that wealthy persons and certain other persons such as lawyers, accountants and businessmen are "sophisticated" investors who do not need the protections afforded by the Act. It is the Commission's view that "sophistication" is not a substitute for *access* to the same type of information that registration would provide . . . . On the other

40 Sec. Reg. & L. Rep. No. 127, G-1 (May 17, 1972).

41 Frome, *Private Placements—Rule 146*, N.Y.L.J., Sept. 10, 1973 at 1.

42 Securities Act Release No. 5336 (Nov. 28, 1972).

43 WHITMAN, *supra* note 32.

44 Securities Act Release No. 5440 (October 10, 1973).

45 17 C.F.R. §230.146 (1974).

46 39 FED. REG. 15261 at 15268 (hereinafter cited as 146 Release).

47 As Rule 146 was promulgated under §19(a) of the 1933 Act, issuers acting in good faith in reliance upon it are shielded from liability under the 1933 Act, even if Rule 146 is later determined to be invalid for any reason.

> hand, the Commission is of the view that an offeree need not be an insider such as an officer or a director of the issuer in order to have access to such information.[48]

This would appear to be a retreat from the extreme position of *Continental Tobacco.*

B. *Rule 146—Preliminary Notes*

The Rule is preceded by seven preliminaary notes, the first of which deals with the question of exclusivity. In simple words, exclusivity means that the private placement exemption would only be available to those who comply with Rule 146, and that the general body of law relating to § 4(2) of the Act would not be available. The question of exclusivity is of great concern to the securities bar. The fear has been expressed that courts and lawyers will be unwilling to take the risk of going beyond Rule 146's boundaries.[49] The Committee on Securities Regulation of the Association of the Bar of the City of New York commented:

> [W]e believe it most important that the Rule as adopted, or accompanying notes, make it very clear that the Rule is non-exclusive, that it is recognized that there are many circumstances not encompassed by the Rule such as those previously mentioned under which transactions would be properly exempted by Section 4(2) and that the requirements of the Rule should not be regarded as defining the scope or ingredients of the Section 4(2) exemption for private placement transactions generally or be incorporated into administrative interpretations applicable to other private placement transactions under Section 4(2). Noting the substantial conditions to the availability of the exemptions set forth in the proposed Rule, the Committee believes that unless there is such an aggressive statement of non-exclusivity it would be preferable not to adopt the proposed Rule.[50]

The Commission responded favorably to the concerns of the bar in this matter and the first preliminary note includes a statement that:

> Transactions by an issuer which do not satisfy all of the conditions of this Rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption may do so by complying with adminis-

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[48] 146 Release at 15261 (emphasis added).

[49] Wander and Shevitz, *Rule 146 Adopted*, THE REVIEW OF SECURITIES REGULATION, June 5, 1974, at 27 (hereinafter cited as Wander and Shevitz). "However, as a practical matter, it [Rule 146] is likely to become exclusive. Courts may tend to apply the more objective standards of the rule where they previously struggled with the ambiguities of the 4(2) exemption, thus rendering compliance with Rule 146 equivalent to compliance with Section 4(2)."

[50] Letter from the Committee on Securities Regulation of the Association of the Bar of the City of New York to the Chief Counsel, Division of Corporate Finance, Securities and Exchange Commission, January 25, 1973.

trative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule does not act as an election; the issuer can also claim the availability of Section 4(2) outside the rule.

Preliminary note 3, pointing to the strictures of paragraph (b) of the Rule states:

> In order to obtain the protection of the Rule, all its conditions must be satisfied and the issuer claiming the availability of the Rule has the burden of establishing in an appropriate forum that it has satisfied them. The burden of proof applies with respect to each offeree as well as each purchaser.

Preliminary note 6 provides that the Rule is available only to the issuer of securities and is not available to affiliates or other persons for sales of the issuer's securities (sometimes known as a "replacement"). Private placements or replacements by non-issuers must find an exemption under § 4(1) of the Act[51] if at all. This exemption is sometimes referred to as the "§ 4(1-½)" exemption, falling somewhere between § 4(1) and § 4(2).[52] Many commentators have felt that there is a serious omission in Rule 146 in not dealing with the § 4(1-½) problem,[53]

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[51] § 4. The provisions of section 5 shall not apply to (1) transactions by any person other than an issuer, underwriter or dealer. . . .
15 U.S.C. §77d(1) (1970).

[52] Wander and Shevitz, *supra* note 49.

[53] *See, e.g.*, Letter of ABA Committee on Federal Regulation of Securities, Subcommittee on Private Offerings to the Securities and Exchange Commission dated January 24, 1973 (hereinafter referred to as Subcommittee Letter):

> Technically, §4(2) of the 1933 Act recognizes a non-public offering exemption for issuers only. Nevertheless, as a matter of administrative practice, the SEC has recognized that holders of restricted securities may resell in transactions not involving a public offering. In fact Rule 144(e)(3)(G) specifically recognizes that securities sold pursuant to an exemption provided by §4(2) are not to be counted in determining the amount of securities that may be sold pursuant to the Rule. The staff of the Division of Corporation Finance has indicated that this reference was intended to mean that a selling shareholder could make a private placement of his security holdings consistent with prevailing interpretations of §4(2).
>
> Now the SEC has proposed Rule 146 which by its terms is inapplicable to secondary transactions. This raises a very serious question as to whether a security holder may still make private placements. It appears that he should be so entitled since Rule 144 is intended to be non-exclusive. Also, what standards are to be adhered to in making any private placements? Apparently, the Commission and its staff must have felt that to make Rule 146 specifically applicable to secondary transactions would fly in the face of the statutory language of §4(2). On the other hand they may have created a no-man's-land.

See also letter by Carl Schneider to SEC dated January 23, 1973:

> The Release, page 2, states that the benefits of the Rule would not be available to persons other than the issuer. This statement is very unfortunate in that it further complicates an already complicated situation. Most lawyers are satisfied that a private purchaser under certain circumstances may make a private resale without violating Section 5 of the Act. However, the statutory exemption for such a transaction is highly uncertain. Although Section 4(2) is generally considered to be the exemption covering private transactions, by its terms it relates only to transactions "by an issuer."

although it could be argued that there is no statutory basis under § 4(2) for such a rule,[54] since § 4(2) by its terms exempts only "transactions by an issuer."

The replacement problem is further complicated by Rule 144[55] which permits sales of

> securities acquired directly or indirectly from the issuer thereof, or from an affiliate of the issuer in a transaction or chain of transactions not involving any public offering[56]

subject to numerical and other restrictions. As originally adopted, Rule 144(e)(3)(g) excluded from the computation of the numerical limit securities sold by the holder thereof "pursuant to an exemption provided by Section 4(2)."[57] In February 1974, the phrase was amended to read "in a transaction exempt pursuant to Section 4 of the Act and not involving any public offering."[58] This was apparently a shift of position by the staff of the SEC from the view that a replacement must find its statutory authority in § 4(2); however, because of the failure to deal with this problem in Rule 146 coupled with the above mentioned change in Rule 144, there is no guidance on the standard for a replacement. A hint is found in a no-action letter issued to Environmental Sciences Corporation which suggests that such sales must be "similar" to § 4(2) transactions.[59] Many questions remain: To how many persons may each

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> Members of the staff have conceded in discussions that private purchasers may resell privately (assuming that a pyramid effect does not result in a broad distribution to a large number of persons), but there is conflict of opinion within the staff as to whether Section 4(1) or 4(2) applies. The confusion was compounded by the enigmatic no-action letter to Gadsby & Hannah, 169 SRLR C-2.
>
> Considering the general purpose of the reform program of which Rule 146 is a part, it would be regrettable to leave this question unresolved. Something in the Rule, or at least in the covering Release, should legitimize the applicability of one exemption or another to private resales.

54 The basis for the exemption under §4(1) is not clear either. The Section exempts "transactions by any person other than an issuer, underwriter or dealer." Section 2(11) defines an underwriter as a person who purchases securities from an issuer with a view to distribution or participates in a distribution and defines "issuer" to include a person controlling the issuer. Consequently, in a sale by a control person through a broker, the broker is an underwriter and the transaction is not exempt. Wolfson v. United States, 405 F.2d 779 (1968), *cert. denied*, 394 U.S. 946 (1969).

55 17 C.F.R. §230.144 (1972).

56 Rule 144 defines an affiliate of an issuer as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. §230.144(a)(1) (1972). Thus, under the facts of the *Wolfson* case, *supra* note 51, had the transaction otherwise been in conformity with Rule 144, the broker's purchase from the defendant would not have constituted a distribution and the transaction would have been exempt under §4(1) of the 1933 Act.

57 17 C.F.R. §230.144.

58 Securities Act Release No. 33-5452 (Feb. 1, 1974).

59 Environmental Sciences Corporation, CCH FED. SEC. L. REP. [1973 Transfer Binder] ¶79,466.

restricted stockholder sell? Does the number depend upon the length of the seller's holding period (*e.g.*, more than the two years specified in Rule 144) or the amount of securities to be sold? Do any suitability or sophistication tests apply to private resales? Are there any requirements on information to be supplied, and how can the seller obtain information if he is not an insider?[60] The unanimous view is that it is urgent that this matter be clarified.[61]

C. *Paragraph (a): Definitions*

The Rule is deceptively short and it is broken into eight paragraphs lettered from (a) through (h). Paragraph (a) provides definitions, the first of which is that of "offeree representative," a new concept in securities law. The offeree representative is defined as a person (and it is clear that there may be more than one offeree representative) who

> has such knowledge and experience in financial and business matters that he either alone or together with other offeree representatives or the offeree is capable of evaluating the merits and risks of the prospective investment.

Ralston Purina never contemplated the concept of an investment representative. This, of course, ignores the reality of much venture capital financing in the United States which is carried on through the private fortunes of wealthy families assisted by their consultants and advisers. In addition to his knowledge and experience, the offeree representative must not have certain close relationships to the issuer; must be acknowledged by the offeree in writing during the course of his transaction to be his offeree representative; and must disclose to the offeree prior to the acknowledgment any material relationships, existing or proposed, with the issuer or its affiliates. It should be noted that the rule contemplates that the offeree representative may be compensated by the issuer provided that there is full disclosure. This is in accord with traditional investment banking procedures in large debt placements.[62]

There are three notes to paragraph (a). The first note states that offeree representatives should consider the applicability of various registration and anti-fraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 and relating to investment advisers under the Investment Advisers Act of 1940.[63] The second requires specific

[60] *See generally* letter of Carl W. Schneider and Charles C. Zall to SEC; Sec. Reg. and L. Rev. #228 P. F-10; Nov. 21, 1973 (hereinafter cited as Schneider-Zall Letter).

[61] *Id. See also*, Schneider Letter, *supra* note 53; Wander and Shevitz, *supra* note 49; and Letter of Carl W. Schneider to Securities and Exchange Commission of March 1, 1974.

[62] *See* WHITMAN, *supra* note 32 at 132; Schneider-Zall Letter, *supra* note 60.

[63] 15 U.S.C. §80b-1 *et seq.* (1970) (hereinafter cited as the 1940 Act).

acknowledgment of the offeree representative as to each prospective investor. Advance blank acknowledgment such as "all securities transactions" or "all private placements" is not sufficient. This will permit the offeree to consider potential conflicts of interest with respect to each investment. The third states that disclosure of material relationships between the offeree representative or its affiliates and the issuer and its affiliates does not relieve the offeree representative of its obligation to act in the interests of the offeree. Perhaps the problems raised by the first note are the "Catch-22" of the whole concept.[64]

The introduction of any new concept into law will usually raise as many questions as it solves. Is there a requirement that the offeree representative make a favorable recommendation or is an analysis sufficient? In a recent speech, Alan B. Levenson, Director of Division of Corporation Finance of the SEC,[65] stated that under the rule there is no express requirement for a recommendation but there is an implicit requirement for communication. What are the due diligence duties of the offeree representative?

One might approach the answer to this question by considering the fact that the offeree himself has no due diligence obligations on his own behalf. Alternatively, some of the cases involving negligent misrepresentations by broker-dealers to their customers should be considered.[66] Here, due diligence requirements have been specifically imposed. It is urgent that the due diligence obligations of the offeree representative be clarified by an interpretative release.

Any civil liability of the offeree representative under the Act would arise under §§ 12(2) and 17 (the anti-fraud section). Section 12(2) establishes a negligence standard[67] for making untrue statements and for

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[64] The Exchange Act and the rules and regulations of the Securities and Exchange Commission promulgated pursuant to it impose certain registration and reporting requirements on brokers and dealers, establish certain financial requirements, regulate a variety of fraudulent practices, and through Regulations T, U and G promulgated by the Federal Reserve Board, regulate extension of credit by brokers and dealers, as well as certain others. The 1940 Act (*supra* note 63) includes registration record-keeping and reporting requirements for persons who for compensation advise others as to the value of securities or the advisability of investing in, purchasing or selling securities. Both carry substantial criminal and civil penalties and expose violators to action by the SEC which could effectively prevent them from engaging in activities involving securities.

[65] Address by Alan B. Levenson at seminar on Private Placements: Implications of New Rule 146, June 3, 1974.

[66] Batchelor v. Legg Co., CCH FED. SEC. L. REP. ¶93,119 (D. Md. 1971); *see also* Hendricks v. Flato Realty Investments, CCH FED. SEC. L. REP. ¶92,290 (S.D. Tex. 1968).

[67] Liability is imposed upon one who "shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known. . . ."

In certain cases a negligence standard may be imposed on offeree representatives under Rule 10b-5 under the Exchange Act. For a recent and extreme statement of this view *see* Hochfelder v. Ernst & Ernst, 43 U.S.L.W. 2120 (7th Cir., August 30, 1974) (auditor which omitting to disclose material information. If the offeree representative acts solely on behalf of the buyer, § 12(2) would probably not be applicable since it applies only to those who offer or sell securities. However, if the offeree representative is found to have acted on behalf of seller as well as buyer (and this may well be likely in many situations), then liability may be imposed.[68]

If an officer or a partner of an investment banking firm acts as offeree representative of an offeree and another partner serves on the board of the issuer, will that make the investment banking firm an affiliate under subparagraph (a)(1)(i) so as to disqualify it from acting as an offeree representative? The answer to this question probably lies in the *Martin-Marietta* case[69] and the concept of deputization of board membership there. If there is deputization so that in effect the investment banking firm itself serves as the director then it would probably be disqualified as an offeree representative. There will undoubtedly be concern as to whether certain classes of persons automatically qualify as offeree representatives: for example, lawyers, accountants, and investment bankers. If a lawyer, must he be a securities or a tax lawyer? If an accountant, a general accountant, tax accountant, or auditor? If an investment banker, a salesman, corporate finance specialist, or analyst? For simplicity's sake, it would be hoped that the Commission will consider automatically qualifying such classes of persons as lawyers, accountants, and investment bankers.[70]

In any event, the Rule requires only that the issuer have "reasonable grounds" to believe that a person qualifies as an offeree representative and provides that the representative may have the requisite knowledge either alone or together with the offeree or other representatives of the offeree.

The definition of the term "issuer" in subparagraph (a)(2) of the

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negligently failed to uncover fraudulent scheme in statutory audit of brokerage house, as required by § 17(a) of the 1934 Act, may be liable to defrauded plaintiffs.)

68 3 L. LOSS, SECURITIES REGULATION 1713 *et seq.*, and Supplement. *See* The Johns Hopkins University v. Hutton, 422 F.2d 1124 (4th Cir. 1970) (broker whose agent omitted to supply material information held liable under §12(2)). In Nicewarner v. Blevins, 244 F. Supp. 261 (D. Col. 1965), the court stated:

> It is well established that persons other than the owner of a security may be liable under 12(1). Such persons include brokers or other agents for the seller, and directors, officers, or controlling persons of a corporation. However, in all instances where a non-owner has been held liable, his conduct has amounted to solicitation of the sale.

Id. at 266. Of course, §16 of the 1933 Act preserves the common law and state and federally imposed duties of offeree representatives (if any).

69 Feder v. Martin-Marietta Corporation, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970).

70 Such an exemption is embodied in the definition of investment adviser under the 1940 Act, §201(11).

rule incorporates the definition in § 2(4) of the Act.[71] There is an exclusion for securities issued by a trustee, receiver or debtor in possession under the Bankruptcy Act—presumably to avoid integration with offerings of securities issued by the debtor prior to the bankruptcy since securities issued by a trustee, receiver, or debtor in possession under the Bankruptcy Act should be exempt under § 3(a)(10) of the Act.[72] To deal with another problem of integration, the first draft of the Rule contained a definition of the term "issuer" for certain offerings involving partnerships. In the SEC synopsis of the Rule it is noted:

> This has been deleted from the Rule as adopted because it was ambiguous and the Commission determined that Rule 146 was not the appropriate place to deal with the question at this time.[73]

This problem often arises when developers in the tax shelter field, such as real estate, oil and gas, or cattle, create successive limited partnerships to sell securities to the public either in registered offerings or under § 4(2) of the Act. If Rule 146 is not the proper place to bring certainty to the area, it is hoped that the Commission will find another forum. The Commission partially dealt with the problem in Regulation A by exempting from the computation of securities offered pursuant thereto:

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[71] Section 2(4) of the 1933 Act provides that:

The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

[72] Section 3(a)(10) of the Act:

(10) Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

[73] 146 Release, *supra* note 46 at 15263; *see* note 79 and accompanying text.

> (4) In the case of an offering of interests in an unincorporated theatrical production, interests in any affiliated unincorporated theatrical production; or
>
> (5) In the case of an offering of interests in an unincorporated issuer organized to hold title to lease, operate, or improve specific real property, interests in any affiliated issuer organized to hold title to, lease, operate or improve other specific real property.[73a]

In informal conversations, the staff of the Commission has indicated that it does not presently have any project pending in this area.

The definition of the term "material" is based upon the opinion of the Supreme Court in *Affiliated Ute Citizens v. United States.*[74] The Court there said that materiality is to be determined from the reasonable investor's point of view and not through some formula measuring the importance of the transaction to the offeree representative or issuer.

D. *Paragraph (b): Conditions To Be Met*

Paragraph (b) of the Rule provides that transactions by an issuer must be "made in accordance with *all* the conditions of this Rule," in order to obtain the benefits of the Rule. In other words, the concept of substantial compliance is not applicable. The difference between complete compliance and substantial compliance may very well involve an offeree to whom no sales of securities were made. Yet, under these circumstances (unless the burden of proof can be sustained that the offering qualified for the § 4(2) exemption outside the rule), it would be a violation of the registration requirements of § 5 of the Act. When an offering violates § 5, *every* purchaser is entitled to rescind his purchase even though he receives complete and accurate information concerning the issuer and the sale was in all other respects proper.[75] Accordingly, an issuer may, at the option of the purchasers, be required to return all of the funds received in a private placement. Such return may result in financial difficulties or disaster to the disadvantage of innocent stockholders who invested in other offerings of the issuer or in that particular offer. These types of infractions do not justify these consequences. Perhaps the best solution to this problem is in the "I & I Defense," proposed by Carl

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73a 17 C.F.R. § 230.254 (d) (1972).

74 406 U.S. 128 (1972) at 154.

75 Section 12 of the 1933 Act provides:

> Any person who (1) offers or sells a security in violation of section 5 . . shall be liable to the person purchasing such security from him . . . [for] the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. . . .

In addition, controlling persons of the issuer may be personally liable under Section 15 of the Act, and Section 24 provides for criminal penalties for willful violation.

W. Schneider and Charles C. Zall.[76] In discussing the adoption of Rule 146 and Rule 147 they raise the question about the substantial civil liability arising under § 12(1) of the Act for a § 5 violation which could result from a failure to comply with any condition of either rule no matter how innocent or immaterial. The consequences would include the right of any purchaser of securities in the transaction to rescind his purchase or recover damages notwithstanding the fact that the innocent and immaterial violation was not committed with respect to him. Schneider and Zall urge that the SEC "adopt a rule creating an issuer's defense against Section 12(1) liability arising out of an innocent or immaterial failure to comply with the terms of an exemption (the 'I & I Defense'). The rule should apply to cases of 'substantial compliance' in 'good faith' . . . ."[77]

The Rule does not define the term "offering." The traditional theology of "integration" has to be applied with all its attendant subjectivity. An older SEC release remains the definitive statement:

> A determination whether an offering is public or private would also include a consideration of the question whether it should be regarded as a part of a larger offering made or to be made. The following factors are relevant to such question of integration: Whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.[78]

If an issuer effects an otherwise valid private offering and subsequently makes a public offering pursuant to a registration statement, then the question may arise as to whether the two offerings are separate and distinct or whether they constitute a single, integrated raising of funds.[79]

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[76] Schneider and Zall, *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I & I Defense,* 28 BUS. LAW. 1011 (1973).

[77] *Id.* at 1012.

[78] 27 FED. REG. 11316, 11317 (1962); Securities Act Release No. 33-4552.

[79] On the matter of integration, *see generally* Goldberg, *Private Placements and Restricted Securities,* 2 SECURITIES LAW SERIES (1973) at 2-133 *et seq.*; Haft, *Tax Sheltered Investments,* 4 SECURITIES LAW SERIES, (1973) at 2-9 *et seq.* (hereinafter cited as Haft); Shapiro and Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always . . . ,* 31 MD. L. REV. 3 (1971). A problem often arises in considering whether two limited partnerships with the same corporate general partner should be considered as one offering. Merely having the same corporate general partner does not seem sufficient grounds to find integration. Letter of Chief Counsel of Division of Corporation Finance to the National Association of Home Builders, dated October 8, 1971, cited in Haft *supra.* But the two limited partnerships may well contract for goods and services with the same entities many of which may be affiliates of the general partner. Assume that the two limited partnerships offer limited partnership interests for cash at approximately the same time. In such a case, is the fact that the limited partnerships are engaged in separate projects, as for example, different cattle herds, different oil wells, or different apartment complexes, together with the separation of entities, sufficient to prevent integration? Or should this be construed as a single plan of financing the business of the corporate general partner, which should be viewed as the actual issuer of the securities,

If the latter, the exemption is lost with respect to the original private offering.[80] Another example of the integration problem arises if an

> offering is made partly to persons in the United States and partly to persons in foreign countries, [then] the *total* number of offerees must be considered in determining the availability of the exemption whether the offering originates in this country or in the foreign country. For example, if ABC, Inc., a Delaware corporation, makes a million dollar stock offering, part of which is purchased for investment by a selected group of 25 or less investment purchasers in this country and the remainder to 200 in Canada, ABC, Inc., has made a public offering.[81]

To provide a safe harbor from the possibility of integration a concept first proposed in Rule 147[82] was continued in subparagraph b(1) of Rule 146:

> an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this Rule; *provided*, that there are during neither six month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as though offered, offered for sale or sold pursuant to the Rule.

It is apparent that lawyers relying on the Rule to provide an exemption for an offering will have to qualify their opinion with respect to subsequent offers or sales during the six month period following the subject sale which may destroy the use of the Rule.

E. *Paragraph (c): Limitations On Manner Of Offering*

In keeping with the concept that a transaction under the Rule must be one "not involving any public offering," the Rule prohibits any form of general solicitation or general advertising, specifically including newspaper advertisements, articles, radio, and television. The concept of limiting general solicitation becomes more sophisticated in dealing with meetings, seminars, and direct written communication. Seminars are permitted if the persons attending meet the requirements of subparagraph

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rather than the limited partnership? Note, *Application of the Securities Doctrine of Integration to Real Estate Syndicates*, 46 S. CAL. L. REV. 428, 454 (1973). These matters are not resolved by Rule 146.

[80] Sowards, *Federal Securities Act* 11 BUSINESS ORGANIZATIONS SECURITIES REGULATION, § 4.02[1] (1973).

[81] *Id.*

[82] 17 C.F.R. §230.147. For an analysis of Rule 147, see Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?*, 35 OHIO ST. L.J 340 (1974)

(d)(1) and with respect to persons qualifying only under subdivision (d)(1)(ii), if such persons are accompanied by their offeree representative(s). With respect to a mailing program such as letters, circulars, or otherwise, the communication must contain an undertaking to provide the information specified by subparagraph (e)(1). This undertaking is applicable whether or not such person eventually becomes a buyer of the securities offered.

One of the first staff no-action letters (or more properly, a refusal to grant a no-action letter) relating to the Rule appeared in connection with an inquiry stating that the issuer "proposed a 'blind advertisement' that will appear in inflight publications" with respect to a proposed offering of oil and gas properties under the Rule.[83] According to the issuer, "the proposed advertisement is designed to identify individuals from what [the issuer].... considers that largest potential participant group of middle and upper echelon business executives who frequently travel by air." It was the view of the staff that because of the proposed reliance of the issuer upon the provisions of Rule 146 there appeared to be serious questions raised as to the availability of an exemption under § 4(2) of the Act should the proposed advertisement contribute to an effort to find proposed offerees of future privately sponsored programs.

F. *Paragraph (d): Nature Of Offerees*

Paragraph (d) on the nature of offerees, is essentially the grandson of *Ralston Purina* out of *Continental Tobacco*. The major consideration is the ability of the offerees to fend for themselves. It would be well before proceeding to further discussion of this paragraph to quote it in its entirety.

> (d) Nature of Offerees. The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:
>
> (1) immediately prior to making any offer, either:
>
> (i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
>
> (ii) that the offeree is a person who is able to bear the economic risk of the investment; and
>
> (2) immediately prior to making any sale, after making reasonable inquiry, either.
>
> (i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or
>
> (ii) that the offeree and his offeree representative(s) together have

[83] Damson Oil Corporation, BNA SEC. REG. & L. REP. No. 261 at C-1 (July 17, 1974).

> such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that offeree is able to bear the economic risk of the investment.

It is apparent in comparing the language of subparagraph (d)(1) with subparagraph (d)(2) that not every qualified offeree is a qualified purchaser. Thus, we are dealing with a two step process: the qualification of offerees and then sorting out from the qualified offerees the qualified purchasers.

The language of subdivision (d)(1)(i) is deceptively simple but raises substantial questions. Must the offeree be capable of specifically evaluating the business of the offeror or is general business experience sufficient? If securities of a computer company are being offered would a commercial banker or an investment banker be a qualified offeree or must we find one who has worked in the computer section of a metropolitan bank or investment banking concern?

It has been suggested that the test in subparagraph (d)(1) is "more demanding than court tests. Under those tests an investor who had access to or was furnished with the requisite information would probably not also have to be sophisticated."[84] The "economic risk" test contained in subdivisions (d)(1)(i) and (ii) was seriously criticized by the bar prior to the adoption of the rule. The Subcommittee on Private Offerings of the Federal Securities Regulation Committee of the American Bar Association raised the question that if the offeree together with his offeree representatives is able to fend for himself, why is it necessary to impose the suitability requirement of being "able to bear the economic risk of the investment."[85] The discussion of Charles S. Whitman III is very much to the point:

> What of the famous sophisticated gamblers? He knows all and is able to fend for himself but goes deep into debt to take down some of the deal anyway. What of the scientist for the company who thinks it is another Haloid and throws everything he has, life savings and all, into company stock? What proof will be required to establish ability to absorb the loss? If you have a net worth of $50,000, how much can you afford to lose? Is it $50,000 or $100,000? No one knows. The Division has all these problems under consideration. It may be impossible to cover them all under a single rule. It is hoped that whatever solution is adopted, the strong nonexclusivity provision will protect the genuine private placement even if it is one of these specialized types.[86]

The two step process of inquiry prior to making an offer presents

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[84] Wander and Shevitz, *supra* note 49 at 914.

[85] Subcommittee Letter, *supra* note 53.

[86] Whitman, *supra* note 32 at 135.

substantial difficulty. Qualification of offerees is not an easy task in that very few offerees are interested in furnishing their net worth statements to offerors prior to the making of an offer and the determination of their interest in the proposed transaction. We might even speculate that some offerees would be reluctant to furnish net worth statements even after the making of the offer.

The determination of the time period becomes more difficult in dealing with stock options and warrants. It would appear that the suitability (if that is the meaning of subdivisions (d)(1)(i) and (ii)) requirements must be met not only at the time of the offer and the sale but also at the time of the exercise. Probably § 3(a)(9) of the Act[87] would provide an exemption for convertible securities so that the offeree would not have to meet the test at the time of the conversion.

G. *Paragraph (e): Access To Or Furnishing Of Information*

We have noted above the development of the concept of "access" in relation to the private placement exemption. It has become a ghost that refuses to vanish. One commentator has suggested that the ghost be exorcised by definition. *Ralston Purina*, according to this commentator, should be interpreted as pointing to only two inquiries with respect to the initial sale: whether each offeree was "sophisticated" and whether each had access to the same kind of information which registration would disclose.[88] In this analysis, the access requirement could be met by an issuer directly by furnishing each offeree appropriate information or indirectly through presumptive access.[89] Presumptive access may be established circumstantially under alternative theories: either the offeree has such an intimate association with the issuer that all sources of relevant information are readily available or he has the power to coerce full disclosure. Nevertheless, the Commission felt constrained to continue the concept in a somewhat watered-down fashion.[90]

Paragraph (e) of the Rule begins with a note explaining that:

> Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship

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[87] Section 3(a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

. . .

> (9) Any security exchanged by the issuer with its existing security holders where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange . . . .

[88] Patton, *The Private Offering: A Simplified Analysis of the Initial Placement*, 27 BUS. LAW. 1089 (1972) (hereinafter referred to as Patton).

[89] Patton, *supra* note 88 at 1092.

[90] *See* text accompanying notes 22 through 32.

> or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment.

It can be argued that access does not arise through economic bargaining power. Any prospective purchaser of securities, no matter how small, may refuse to purchase unless he has been furnished such information as he may demand. If he should choose not to buy without the requested information, he obviously is not damaged.

In lieu of "access" the issuer must furnish each offeree or his offeree representative(s), or both, information specified in Schedule A of the Act. In case of an issuer subject to the reporting requirements of the Exchange Act, a package consisting of the information contained in a registration statement on Form S-1 under the Act or on Forms 10 or 10-K under the Exchange Act, whichever is more recently required to have been filed, and the information contained in any definitive proxy statement[91] required to be filed under the Exchange Act, and any further reports required to be filed under the Exchange Act since the filing of such annual report or registration statement is sufficient. It might be suggested that the Commission by interpretive release should exclude from the last category certain less significant documents, such as preliminary proxies[92] and Schedule 13-D's.[93] There must also be included a brief description of the securities being offered, the use of the proceeds from the offering and any material changes in the issuer's affairs which are not disclosed in the documents furnished.

Issuers not registered under the Exchange Act must furnish the information that would be required to be included in a registration statement filed under the Act on the form which it would be entitled to use. However, if the issuer does not have audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, the financial statements may be provided on an unaudited basis. There is an exclusion for exhibits if they are otherwise made available.

The requirements above may seem simple enough but in practical application they prove to be much more difficult. Registration statements

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[91] Required by Rule 14a-3 (17 C.F.R. §240.14a-3) under the 1934 Act. The Report on Form 10, the Annual Report on Form 10-K require similar information to business and management of issuers and, taken with the disclosures required by Item 7 of Schedule 14A (17 C.F.R. 240.14a-101), relating to remuneration and transactions with affiliates, provide substantially the same information as Form S-1.

[92] 17 C.F.R. 240.14a-6.

[93] 17 C.F.R. 240.13d-101. The form was established to carry out the provisions of § 13(d) of the 1934 Act and must be filed by certain defined persons who acquire more than five percent of any equity security of a class of stock registered pursuant to Section 12 of the 1934 Act. 17 C.F.R. 240.13d-1.

contain pie charts, graphs,[94] "Part II materials,"[95] and financials prepared in accordance with Regulation S-X.[96] An important section of most prospectuses for venture companies is the one headed "Risk Factors."[97] Would the omission of this section for a company subject to the reporting requirements of the Exchange Act be inherently misleading under Rule 10(b)-5?[98]

In addition, prior to the sale, the offeree and his offeree representative, if any, must have the opportunity to obtain additional information necessary to verify the accuracy of the information received, to the extent the issuer has such additional information or can get it without unreasonable effort or expense; and the opportunity to ask questions of and receive answers from the issuer or any person acting on its behalf concerning the terms and conditions of the offering. (We might speculate on the inherent problems if, for example, the offeree and his offeree representative should ask to review the issuer's projections.)[98a] This information need not be furnished to those offerees who are eliminated as prospective purchasers unless an undertaking required by paragraph (c)(3) was made in connection with a meeting or seminar. It is difficult to see what purpose can be served by continuing to furnish this information. In any event it should be noted that the offeree under Rule 146 receives far greater privileges in this regard than an offeree of a registered offering. Correlatively, the issuer does not have the protection from anti-fraud charges inherent in restricting his communications to the written prospectus as is the procedure in a registered offering.

Under the disclosure required by paragraph (e)(3), the issuer or any person acting on behalf of the issuer must disclose to each offeree in writing prior to sale (i) any material relationship between his offeree representative(s) or its affiliates and the issuer and its affiliates which then exist or is mutually understood to be contemplated or which has existed any time during the previous two years and any compensation received or to be received as a result of such relation; (ii) that the purchaser of the securities must bear the economic risk of investment for an indefinite period because the securities have not been registered under the Act and therefore cannot be sold unless they are subsequently registered under the Act or an exemption from such registration is available; and (iii)

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94 Guide 6 of Guides for Preparation and Filing of Registration Statements, 33 FED. REG. 18617 (1968) (hereinafter cited as Guides).

95 Part II of Form S-1, CCH FED. SEC. L. REP. ¶7124.

96 17 C.F.R. § 210.1-01 *et. seq.* (1974).

97 *See, e.g.* Guide 55 and Proposed Guide 60 of Guides, *supra* note 94.

98 17 C.F.R. §240.10b-5.

98a Levy v. Douglas Aircraft Co., Inc., 374 F. Supp. 341 (S.D.N.Y. 1974).

the fact that there will be restrictions on the disposition of securities which will be noted thereon.

H. *Paragraph (f): Business Combinations*

One must approach this section of the Rule with a sense of history. Prior to *Continental Tobacco* and Rule 133,[99] business combinations presented one of the easier opinions a securities lawyer was called upon to give. Rule 133 provided in substance that the distribution of securities in a tax free reorganization under §§ 368(a)(1)(A) or (C) of the Internal Revenue Code of 1954 did not constitute a sale of securities and therefore registration was not required. In 1954, it was broadened by the adoption of an amendment providing for the "leakage" of securities acquired in the business combination by affiliates of the acquired company who were permitted to dispose of a limited amount of securities in every six month period. As long as Rule 133 held sway, no one worried about the availability of the private offering exemption in acquisition transactions. Quite the contrary, everything was done to avoid this section because the Commission had carved out an exception to Rule 133 called the "negotiated transaction." Essentially, the "negotiated transaction" theory was that if the numbers of shareholders of the acquired company were few then the "sale" was not effected by the vote of the shareholders but rather by negotiations between the acquiring company and each of the few sellers. It was assumed that if one failed to qualify under Rule 133, the § 4(2) exemption would be automatically available. The difference was that under Rule 133, non-affiliates of the acquired company could immediately re-sell the securities and even affiliates had the leakage provisions available to them. Under § 4(2) the acquired securities were locked up for as much as three years.

The Wheat Report[100] led to the repeal of Rule 133 by the substitution of Rule 145[101] and *Continental Tobacco* was decided at about the same time. Rule 145 treats a business combination as a sale of securities. It was in this context that Rule 146 was adopted. The consensus seemed to be that it did not treat business combinations too kindly although in the final version some improvements were made over earlier proposals.[102]

Paragraph (f) carves out an exception to the paragraph (d) require-

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99 17 C.F.R. §230.133.

100 F. WHEAT, DISCLOSURE TO INVESTORS (1968).

101 17 C.F.R. § 203.145. For a discussion of Rule 145 see Schneider and Manko, *Rule 145, An Analysis and Appraisal*, 5 REV. SEC. REG. 811 (1972), 6 REV. SEC. REG. 991 (1973) (hereinafter cited as Schneider and Manko).

102 *Id.*

ments as to the nature of the offerees for business combinations. It also eliminates the provision requiring the purchaser to furnish an investment letter.[103] In subparagraph (f)(3), the Rule requires that:

> [The] issuer (and any person acting on his behalf), after making reasonable inquiry, shall have reasonable grounds to believe, and shall believe, at the time that any plan for a business combination is submitted to security holders for their approval, that each offeree either alone or with his offeree representative(s) has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and the risks of the prospective investment.

The issuer is required by subparagraph (f)(4) to provide in writing to each offeree at the time the plan is submitted to security holders for approval, information about any special terms or arrangements of the proposed transaction relating to any security holders.

It should be noted, first of all, that the requirement that the offeree be able to bear the economic risk of investment has been eliminated from paragraph (f). The Commission's comments regarding subparagraph (f)(3) demonstrate an awareness of the difficulties that may be created by the requirement that each offeree either meet the required sophistication standards or have an offeree representative:

> Subparagraph (f)(3) means that an offeree who needs an offeree representative in order to satisfy the knowledge and experience test, and who refuses to have one, may make the Rule unavailable for the transaction. Numerous comments on this point were received in response to a similar condition in the Rule as last proposed. Although the Commission is aware of the possible problems this may cause, the Commission does not believe that it can allow satisfaction of the state corporate law requirements as to business combinations to replace satisfaction of the federal securities laws.[104]

In effect, the Commission has said that the generally accepted provision of corporate law relating to the right of holders of a majority or two-thirds of the shares to determine the future of the corporation is overridden by Rule 146 so that a recalcitrant minority may frustrate an acquisition or force alteration of its terms in order to specially benefit itself. This problem was ably dealt with by various commentators on earlier versions of the Rule. Especially to the point are the comments of Schneider and Manko:

> [S]tate law does not assure all . . . [stockholders of the acquired company] that they will receive a suitable security when their company is acquired. Quite to the contrary, the will of the specified majority (typi-

[103] Required by Subparagraph h(4) of Rule 146.

[104] 146 Release, *supra* note 46.

> cally a simple majority or two-thirds) binds all stockholders, their only alternative being appraisal right in some instances. This fundamental ground rule of state law, and the inherent risks assumed by each stockholder when he makes an investment . . . , indeed should not be overridden by the 1933 Act, a federal law oriented toward disclosure. As indicated above, Rule 146 might well give undue leverage to a recalcitrant minority to frustrate acquisition, to alter its terms or to force special treatment for itself (e.g., a cash buyout).[105]

It was somewhat loosely contemplated when the Rule was adopted that the stockholders of the acquired company might very well designate the management of their company or one of its officers as their offeree representative. In this connection, it should be noted that the management group or even its counsel in many situations may not possess the necessary degree of sophistication. This does not mean however that they will not be able to perceive the value of the shares of say, an AT&T or a General Motors in exchange for their own. Also, the man agement group may be unwilling to accept the relationship, first because of liability they would be assuming and second because there often would be conflicts of interest between their own personal interests (as in continued employment) and those of minority stockholders. Serious questions may be raised as to the applicability of the offeree representative concept to the business combination situation.

An appropriate solution to the offeree representative problem would be to eliminate the requirement of an offeree representative for business combinations,[106] and to require officers and directors to disclose to shareholders any interest they may have in the proposed combination at the time they recommend it. Protection of minority shareholders would be left to the antifraud statutes and general common law duties of directors[107] and the majority shareholders.[108]

Paragraph (f) does not apply to an exchange of securities for securities. Yet, even in the exchange situation, the acquiring corporation most take shareholders of the acquired corporation as it finds them. In comments to the Rule, it is noted that "in an exchange offer the issuer has a choice of offerees and therefore does not need the special provisions of paragraph (f)." If there are thirty-five stockholders in the acquired corporation, thirty of whom meet the tests of paragraph (f)(3) and five who do not, what are the issuer's choices? To exchange securities with the thirty and attempt a "force-out merger" for the balance? Even here

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105 Schneider and Manko, *supra* note 101, at 994.

106 Id. at 995.

107 For a general discussion of these duties see 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838 (perm. ed. 1965) and cases cited.

108 *See, e.g.*, Perlman v. Feldman, 219 F.2d 173 (2d Cir. 1955).

the corporation must comply with Rule 146. To exchange with the thirty and leave a minority, or to register securities for the benefit of the recalcitrant five who may prefer not to read the prospectus?

The application of paragraph (e) (Access To or Furnishing Information) to business combinations is especially difficult. Access on the part of all of the acquired corporation's stockholders to their own company cannot be assumed. The careful purchaser for his own protection, will undoubtedly assume the contrary. Under Rule 145, the stockholders of the acquired company are entitled to full information about both companies, the issuer and their own company. In addition, they are entitled to pro forma combined financial information.[109] In the case of the large public company acquiring a small private one, much of this information would be meaningless.

I. *Paragraph (g): Number Of Purchasers*

The private placement exemption has always been surfeited with numbers. In 1935, it was stated that:

> The opinion has been previously expressed by this office that an offering to not more than approximately 25 persons is not an offering to a substantial number and presumably does not involve a public offering . . . You will note that this does not mean the number of actual purchasers but the number of persons to whom the security in question is offered for sale.[110]

As a result of this opinion, the rule that no more than twenty-five offerees would not result in a public offering became firmly imbedded in the consciousness of those dealing with securities law.

In *Ralston Purina*, the issue is raised by both sides as to the defendant's contention that its offer was confined to a select group. The Supreme Court responded that this was irrelevant as "the statute would seem to apply to a 'public offering' whether to a few or many."[111] On the other hand, in the same case the SEC attempted to persuade the Court that apart from other criteria there should be a limitation in the application of the exemption to a relatively few persons. The Supreme Court rejected the contention saying:

> [Nothing] prevents the commission, in enforcing the statute, from using some kind of numerical test in deciding when to investigate particular exemption claims. But there is no warrant for superimposing a quantity limit on private offerings as a matter of statutory interpretation.[112]

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[109] Item 15 of Schedule 14A (17 C.F.R. §240.14a-101).

[110] Release 285, *supra* note 10.

[111] 346 U.S. 119, 125 (1953).

[112] *Id.*

The SEC spent the next several years trying to retreat from its "25 offerees" position. In a 1962 release, the Commission said:

> It should be emphasized therefore that the number of persons to whom the offering is extended is relevant only to the question where they have the requisite association with and knowledge of the issuer which make the exemption available.[113]

The concept of Rule 146 was first spelled out by the Chairman of the Securities and Exchange Commission, William Casey, on August 15, 1972, in an address to the Section on Corporation, Banking and Business Law of the American Bar Association.[114] Thirty-five *buyers* were suggested as the appropriate numerical limitation. Chairman Casey noted that thirty-five was also the maximum number of non-institutional purchasers permitted by the proposed ALI Federal Securities Code,[115] and the maximum number of purchasers permitted by the proposed legislation submitted by the SEC to regulate offerings in the oil and gas industry.[116]

Paragraph (g) of the Rule begins "(1) There shall be no more than 35 purchasers of the securities of the issuer from the issuer in any offering pursuant to the Rule." The Rule as originally proposed[117] provided that not more than 35 persons in any consecutive 12 months period shall purchase securities of the issuer in transactions pursuant to the Rule or not pursuant to the Rule but in reliance upon § 4(2). The changes that developed were a significant improvement. The rolling 12 month period concept was eliminated and the concept of the "offering" substituted. The paragraph goes on to provide specific provisions for determining who are purchasers. For the purposes of computing the number of purchasers, some purchasers would be excluded: relatives, spouses and relatives of spouses who live in the same home with the purchaser; trusts, estates, and corporations of which the purchaser is substantially the sole beneficiary or stockholder; and a person who purchases or agrees in writing to purchase for cash in a single payment or in installments, securities of the issuer in the aggregate amount of $150,000 or more. Paragraph (g) goes on to note that corporations, partnerships, and similar entities may be counted as a single purchaser unless they were organized for the specific purpose of acquiring the securities offered. Although the release accompanying the Rule provides no explanation for the exception for purchasers of $150,000 or more of securities, it was apparently designed

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113 27 FED. REG. 11316 (1962).

114 BNA SEC. REG. & L. REP. No. 165 at F-1 (August 16, 1972) (hereinafter cited as Casey).

115 ALI FEDERAL SECURITIES CODE (Tent. Draft #1, 1972).

116 The Oil and Gas Investment Act of 1973, S. 1050, 93rd Cong., 1st Sess. (1973).

117 *See* note 42, *supra.*

to permit an unlimited number of institutional investors. In Chairman Casey's August 1972 address,[118] a \$50,000 to \$100,000 standard for exemption from numerical limitation was suggested. This later rose to \$250,000 in the proposed Rule. In contrast, the proposed Federal Securities Code adopted an exemption for "institutional investors"[119] without regard to the dollar amount purchased.

Preliminary note 5 (much to the surprise of commentators) reversed an old SEC position on discretionary accounts exemplified by a "no-action" letter by Baldwin B. Bane, stating that a trustee with forty-four discretionary accounts would be considered one person in counting investors under the private placement exemptions.[120]

J. *Paragraph (h): Limitations On Disposition*

This portion follows the historic trend of the SEC with respect to limitations on dispositions,[121] requiring reasonable inquiry to determine if the purchaser is acquiring securities for his own account or on behalf of other persons, a restrictive legend on the stock certificate, stop-transfer instructions and an agreement signed by the purchaser that the securities will not be sold without registration under the Act or an exemption therefrom. The explanatory material contained in the release states "[t]he Commission believes that these limitations are necessary in order to protect the public from a deferred distribution." The accompanying note points out that in the business combination situation described in paragraph (f), the written agreement is not required. This obviously is so that one recalcitrant party to a business transaction would not be in a position to block the entire transaction.

Stepping back and looking at paragraph (h) from a distance, we might well ask whether if, in fact, no distribution has taken place, should failure to comply with any part of paragraph (h) (remember that "*all* the conditions of this Rule" must be complied with) defeat compliance with the Rule or whether the Commission at this point has put the premium on paper work and lawyering at the expense of substance.

III. A TRANSACTIONAL ANALYSIS

It may be helpful to consider the application of the Rule to a hypothetical transaction and the documentation that may be required. For this purpose, let us assume that we have a subdivision (d)(1)(ii) offeree,

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118 Casey, *supra* note 114.

119 Discussed *infra* at 772

120 Whitman, *supra* note 43 at 136-37.

121 *See* 27 FED. REG. 11316 (1962).

i.e. an offeree who "does not have such knowledge and experience in financial and business matters so that he is capable of evaluating the merits and risks of a prospective investment." We are approaching the Rule from the transactional point of view. We shall be carefully mindful of the Commission's admonition (Preliminary Note 3) that:

> [In] order to obtain the protection of the Rule, all its conditions must be satisfied and the issuer claiming the availability of the Rule has the burden of establishing, in an appropriate forum, that it has satisfied them. The burden of proof applied with respect to each offeree as well as each purchaser . . ."

(1) Assuming no "access," the issuer must be prepared to provide an offering circular that complies with subparagraphs (e)(1) and (2).

(2) The issuer (and any person acting on his behalf) must obtain documentary evidence prior to making any offer that the proposed offeree is a person who is able to bear the economic risk of the investment. This will require a questionnaire and financial statements. Subparagraphs (d) (1) and (2).

(3) The issuer cannot proceed to make a sale to such offeree until the offeree designates his offeree representative in writing. Subparagraphs (a)(1) and (3).

(4) The issuer must document the fact that the offeree representative meets the conditions of subparagraphs (a)(1) and (2), *i.e.* that the offeree representative is not an affiliate, director, officer, or other employee of the issuer or beneficial owner of 10% or more of any class of the equity securities or 10% or more of the equity interest in the issuer except where the offeree is related to such person by blood, marriage or adoption, no more remotely than first cousin and further excepting any trust or corporation with respect to which persons with the specified relationship are the sole beneficiaries or equity security holders. Subparagraphs (a)(1) and (2), of course, provide that the offeree representative either alone or together with other offeree representatives or with the offeree is capable of evaluating the merits and risks of the prospective investment. This will require a suitable questionnaire.

(5) The issuer must further document that the offeree representative has made the disclosure required by subparagraph (a)(1)(4) with respect to material relationships with the issuer.

(6) The issuer must now furnish to the offeree and his offeree representative the information specified in subdivision (e)(1)(ii).

(7) The issuer should document compliance with subparagraph (e) (2) with respect to the opportunity to ask questions and receive answers concerning the terms and conditions of the offer. This documentation

should be carefully maintained not only for the purposes of assuring compliance with subparagraph (e)(2) but also the various anti-fraud provisions of § 10(b) and Rule 10b-5 of the Exchange Act and §§ 12(2) and 17(a) of the Securities Act.

(8) The issuer must disclose in writing to the offeree prior to sale the matters set forth in subdivisions (e)(3)(i), (ii), and (iii) which relate to the relationship of the issuer to the offeree representative, that the offeree must bear the economic risk of the investment for an indefinite period of time because the securities have not been registered under the Act and the limitations on disposition of the securities because of the fact that they are restricted securities.

(9) If an undertaking has been given pursuant to subparagraph (c)(3), then even though the offeree determines not to purchase he still must be provided in writing with appropriate information.

(10) The issuer must document the number of purchasers so that there are not more than thirty-five purchasers as provided in paragraph (g) using the methods of computation provided in subparagraph (g)(2). Satisfactory documentation must be maintained with respect to any corporation, partnership, association, joint stock company, trust or unincorporated organization that is a purchaser that such entity was not organized for the specific purpose of acquiring the securities offered if there is any question about the number of purchasers. Subdivision (g)(2)(ii).

(11) The issuer must document the "reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons." Subparagraph (h)(1).

(12) The issuer must place a legend on the certificate for the securities purchased stating that the securities have not been registered under the Act and setting forth restrictions on transferability. Subparagraph (h)(2).

(13) The issuer must issue the appropriate stop-transfer instructions to the transfer agent and, of course, maintain a record of the issuance of such securities. Subparagraph (h)(3).

(14) The issuer must obtain from the purchaser a written agreement that the securities will not be sold without registration under the Act or exemption therefrom. Subparagraph (h)(4).

This list does not include the usual accouterments of a securities transaction such as the subscription agreement, counsel's opinion, or directors' resolution. A sophisticated purchaser will undoubtedly desire a purchase agreement containing appropriate representations relating to the business and financial affairs of the issuer, representations that the transaction is in compliance with the Rule and more detailed representations relating to the "safe harbor" integration rules in subparagraph (b)(1).

Compare these complexities with the American Law Institute's project for a completely new statutory approach for federal securities law, for which Professor Louis Loss is the Reporter. The private offering exemption is approached with beautiful simplicity. Section 227 of Tentative Draft Number 1 of the Federal Securities Code[122] provides an exemption for a "limited offering" which is defined as an offering in which (a) the initial buyers of the securities are institutional investors and not more than thirty-five other persons, (b) resales of any securities before three years (or one year in the case of certain issuers who have filed with the SEC) after the last sale to any of the initial buyers do not result in more than thirty-five owners of those securities (apart from institutional investors and persons who become owners otherwise than by purchase) at any one time, and (c) the original offeror and all subsequent sellers have complied with rules relating to restrictions on transfer. General advertising is prohibited in connection with the distribution but not as a condition precedent to the exemption. Questions of disclosure and suitability are left to the general anti-fraud provisions of the Federal Securities Code.

IV. Section 4(2) Outside of the Rule

What is the present status of the private placement exemption outside of the Rule? As we have noted earlier, the Rule is not exclusive. "Issuers willing to rely on that exemption [§ 4(2)] may do so by complying with administrative and judicial interpretations in effect at the time of the transaction."

Since the risk of inadvertent failure to comply with the Rule is so great, attention is now being focused on what is left of the § 4(2) exemption outside the Rule. Thus, in an article immediately prior to the adoption of the Rule, it was said:

> [A]s has been generally recognized, however, extremely broad dicta in Commission as well as court cases leave considerable doubt as to whether the exemption outside of the Rule remains viable. There are certain requirements repeatedly announced, for example, the fact that all of the offerees must have a prior relationship with each other, which simply do not reflect prevailing commercial practice or the policy considerations underlying the Act . . . accordingly, if the Rule is adopted, an interpretative release should redefine the general scope of the exemption outside of the Rule. Such a release should note the essential features to establish the exemption, and should eliminate as *sine qua non* factors the nonessential secondary features which have crept into the dicta . . .[123]

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122 ALI, Federal Securities Code § 227 (Tent. Draft # 1, 1972).

123 Schneider-Zall Letter, *supra* note 60.

Members of the Securities Act Subcommittee, Federal Regulation of Securities Committee, under the guidance of Carl W. Schneider are presently considering a project wherein the Committee might formulate its own comments on the residual law which would then be published for the general guidance of the bar. In this work, four factors were identified as the important elements of the existing residual law:

> (1) The offerees are appropriately qualified.
> (2) The manner of the offering is appropriately limited.
> (3) The offerees either have independent access to information about the issuer or are supplied with information about the issuer. The information should be significant in scope but need not conform to all the full detailed requirements of a Form S-1 registration statement.
> (4) There is no public redistribution of the securities sold in the transaction so that the transaction as a whole constitutes a public distribution.[124]

It is interesting to test this formulation in the light of an example given by one objecting member:

> In order to try to make clear why I have a fundamental objection to this formulation, I would like to suggest for your consideration the following case. Two electronic engineers working for one of the aerospace companies in Los Angeles desire to form a new corporation to manufacture equipment. Each of them has a Ph.D. in Physics and 15 years experience in the business. They need an additional $50,000 in cash to launch their enterprise and one of them decides to approach his aunt in Minneapolis, by whom he was raised after his parents' death when he was four years old and who is now a widow that inherited $150,000 from her husband when he died. She takes $50,000 out of her savings and loan association in which she has the $150,000 deposited and gives it to them for one-third of the stock and each of them also takes one-third of the stock, whether with or without some promotional factor in connection with the amount of their cash investment.
>
> It is my opinion that a rule which would say that a registration must be filed and a prospectus delivered to Aunt Minnie before this transaction can be accomplished (or even an offering circular under Regulation A) cannot be labeled other than insane. I also have no question in my mind but that this transaction qualifies for the private offering exemption and always has and always will, despite the dicta by various courts, which you rightly criticize as being unsupported by any actual decisions. Yet it would completely fail to meet at least two of your four "sine qua nons."[125]

Somewhere out there is a private placement exemption under § 4(2) even though Rule 146 has not been complied with.

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[124] Letter of Carl W. Schneider to The Members of the 1933 Act General Subcommittee of June 5, 1974.

[125] Letter of Harold Marsh, Jr. to Carl W. Schneider, dated June 20, 1974.

Prior to the adoption of the Rule, the staff of the SEC had a format for responses to requests for no-action letters relating to the availability of the § 4(2) exemption that went approximately as follows:

> The staff is unable to say whether the Section 4(2) exemption is available to this company's offering of its securities since that exemption depends upon a factual determination the staff cannot make as to whether the prospective offerees meet the SEC v. Ralston Purina tests.[126]

A recent no-action letter by the staff of the SEC[127] suggests that the staff of the Commission is itself re-examining its thinking in this whole area. The no-action letter involved a public sale of pledged securities in order to conform with the notice of reasonableness requirements of § 9-504 of the Uniform Commercial Code. It was proposed that the shares be publicly offered and that notice of such sale be published in the newspapers. The shares would be sold only as a block, the purchaser would be required to give an investment letter, shares would be legended, and a stop-transfer order would be noted in the stock transfer books. Prospective purchasers would be restricted to persons who had been furnished with adequate information about the issuer, were sophisticated purchasers and would not purchase with a view to resale or distribution. The counsel requesting the no-action letter concluded his letter by stating that that transaction could be viewed "as a public offering leading to a private sale in which there is no practical need for registration or where the public benefits of registration are too remote to require registration." The staff responded that it would not recommend any action to the Commission if the proposed transaction is effected without compliance with § 5 of the Act:

> However, this view is contingent upon the additional condition that the notice of sale include the following provisions: the securities may be sold to only one individual purchaser for his own account and not as a representative of purchasers other than himself and that the purchaser may not resell the securities publicly without compliance with the registration provisions of the Act.[128]

It is interesting to note that the offers will be made publicly and that

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126 Kenai Air Service, Inc., avail. 2/4/74; *see also* Associated Developers of Florida, Inc., avail. 3/1/74; Service Life Insurance Company of Omaha, avail. 3/4/74; Thermal Components, Inc., avail. 3/14/74; Woodland Beach Resort, Inc., avail. 3/18/74; Southwest Canners, Inc., avail. 3/28/74; AutoBale America Corp., avail. 4/8/74; National Basketball Trainers Assn., avail. 4/10/74; Amgo, Inc., avail. 4/10/74; All Points Home Purchase Corp., avail. 4/12/74; Alyeska Equipment Corp., avail. 4/17/74; American Guaranty Financial Corp. Administration Trust Co., avail. 4/29/74.

127 Elwill Development Limited, avail. 8/14/74, BNA SEC. REG. No. 265 at C-1 (August 28, 1974).

128 *Id.*

there are no restrictions on the number of offerees. This letter suggests that the staff of the SEC has reversed the practice of counting offerees. It should be further noted that not only are the number of offerees not limited but obviously they need not have a relationship to one another, be of a particular class or be of a class that has a particular relationship with the issuer. On the other hand, the number of purchasers is limited to one. It is difficult to determine the theoretical basis for this limitation. It is possible that this no-action letter could be significant as reflecting a major shift in emphasis; on the other hand, it may prove to be an isolated response to an unusual situation.

What is a simpler solution? The literal language of the Act exempts "transactions by an issuer not involving any public offering" from the registration requirements of § 5. Despite the language of Viscount Sumner,[129] we know that one person is not a public.

It is the author's view that the present status of the private placement exemption can only be improved by disregarding some of the dicta in *Ralston Purina* and perhaps returning full circle to the famous letter of the General Counsel released January 24, 1935 (when the Act was young). Let us review and note some extracts from that letter:

> Furthermore, the opinion has been expressed that under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering . . . . [A]gain, in determining what constitutes a substantial number of offerees the basis on which the offerees are selected is of greatest importance. Thus, an offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all members of a particular class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering . . . . [I]f the denomination of the units are such that only an insubstantial number of units is offered, presumably no public offering would be involved . . . . I feel that transactions which are effected by direct negotiations by the issuer are much more likely to be non-public than those effected through the use of the machinery of public distribution.[130]

The author feels that if we could start all over and develop the law from this point appropriate guidelines could be developed for the non-public offering exemption. The touchstones should be: (1) is a public offering involved (number of offerees, class of offerees, etc.) and (2) is there a

129 The public . . . is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve: perhaps even one, if he is intended to be the first of a series of subscribers, but makes further proceedings needless by himself subscribing the whole. [1929] A.C. 158, 169.

130 Release 285, *supra* note 10.

practical need for the application of the Act or are the public benefits too remote (*i.e.* do we really want the public and private expense of registration for a single sale to Aunt Minnie.)

What is needed is a re-reading of *Ralston Purina*. What the Supreme Court really said was "absent such a showing of special circumstances, employees are just as much members of the investing 'public' as any other neighbors in the community." The Supreme Court was dealing with a situation in which there were from 400 to 1,000 purchasers of stock in a space of three years and offers to sell to 500 (sales were stopped by the litigation) in the fourth year. Of course, these 1,000 employees are members of the investing public and sales to them constitute a public offering. We can easily sympathize with the Court's decision. The Court did not have before it the question of whether sales to thirty-five artists, bake shop foremen, chow loading foremen, clerical assistants, copywriters, electricians, stock clerks, mail office clerks, order credit trainees, production trainees, stenographers and veterinarians over a space of three years would have constituted a public offering. Despite the Court's language that "an offering to those who are shown to be able to fend for themselves is a transaction not involving any public offering" and "the focus of inquiry should be on the need of the offerees for the protections afforded by registration," we suggest the court would have reached the conclusion, under those circumstances, that "the public benefits are too remote," and that a sale by an issuer to thirty-five of its employees was a transaction "by an issuer not involving any public offering."

V. COMMENTS

The ghost of *Ralston Purina* haunts Rule 146. One yearns for a simpler solution. Are the complicated processes of registration necessary in order for a young man to secure his relatives' investment in his business? Aren't the "public benefits" too remote? There are, of course, other safeguards in our various state and federal securities laws. Most states regulate the sale of securities in some manner. Section 10(b) and Rule 10b-5 of the Exchange Act effectively deal with misrepresentation, material omission, and fraudulent courses of conduct. The wisdom of Louis Loss employed in § 227 of the proposed Federal Securities Code is the most clear-cut objective solution yet suggested. It will undoubtedly require legislative sanction. The SEC, given its present posture, vis-à-vis *Ralston Purina*, will probably not replace Rule 146 in this manner. It is to be hoped that the adoption of the ALI Federal Securities Code will not be too many years in the future.

During the interim period, one measure of relief that may be provided from the strictures of Rule 146 is found in the exemptive powers of the SEC set forth in § 3(b) of the Act.[131] In the past, the Commission has exempted public offerings of securities up to the $500,000 limit under the provisions of Regulation A[132] and the sale of fractional interests in oil and gas rights to $250,000 under the provisions of Regulation B.[133] Several special kinds of securities, such as first lien notes,[134] securities of co-operative housing corporations,[135] and securities to provide funds in lieu of issuing fractional shares or scrip certificates,[136] have also been exempted. Regulation A requires an offering circular that closely approximates a prospectus under § 5 of the Act. Regulation B requires a special questionnaire to be answered which may be prepared without the services of one skilled in the obscure art of securities writing. Regulation 257, relating to offerings that do not exceed $50,000, dispenses with the offering circular entirely.

Section 3(b) provides power to grant the exemption if the Commission "finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by the reason of the small amount involved or the limited character of the public offering." Until recently there has been little attention paid to the phrase "limited character of the public offering." On June 3, 1974, the SEC proposed Rule 240.[137] The proposed Rule provides a transactional exemption from § 5 of the Act by reason of § 3(b) of the Act.

In substance, Rule 240 is only available to corporate issuers. There can be no general advertising or commissions paid for sales. The aggregate sales price of all securities of the issuer (with very limited exceptions) under the Rule or otherwise without registration cannot exceed $100,000 in twelve months. There can be no more than twenty-five persons that purchase from the issuer and no more than fifty beneficial owners of securities of the issuer after consummation of the sale. Resales are limited and a notice is required to be filed with the regional

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[131] The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $500,000.

[132] 17 C.F.R. § 230.251-62.

[133] 17 C.F.R. § 230.300-46.

[134] 17 C.F.R. § 230.234.

[135] 17 C.F.R. § 230.235.

[136] 17 C.F.R. § 230.236.

[137] Securities Act Release No. 33-5499 (June 3, 1974), 39 FED. REG. 20609 (1974).

office of the Commission within ten days prior to the first sale. By this brief summary, it may be perceived that proposed Rule 240 is very limited in scope and possible benefit.

The SEC should look to § 3(b) as an appropriate statutory sanction for § 227[138] of the proposed Federal Securities Code and put it into effect without waiting for the passage of the many years that necessarily will take place before Congress will enact it. This would provide a procedure for making a private offering that would not require the "Wall Street" sophistication inherent in the provisions of Rule 146. Thus, our new "limited offering" (the term used by Professor Loss in § 227) would have the following characteristics:

(a) the aggregate amount at which the issue is offered to the public would not exceed $500,000;

(b) it would be available to non-corporate as well as corporate issuers;

(c) there could be no general advertising or general solicitation;

(d) a commission could be paid;

(e) there need be no restriction on the number of beneficial holders of the issuer's securities either before or after the issue;

(f) thirty-five purchasers would be permitted under generally the same kinds of conditions and restrictions as are found in Rule 146 and proposed Rule 240;

(g) the securities would be subject to the same limitations on resale as are found in Rule 146 and proposed Rule 240; and, in addition, resales of any of the securities involved in the offering before a date three years after the last sale to any of the initial buyers (one year in case of registrants under § 12 of the 1934 Act) should not result in more than thirty-five owners of those securities at any one time.

(h) a notice to the SEC similar to that found in proposed Rule 240 would be required; and

(i) the issuer would be required to deliver an offering circular which would provide a simplified version of the information required in Schedule 1A under Regulation A. This offering circular would not be reviewed by the SEC.

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[138] *See* note 123 *supra* and accompanying text. A comment letter prepared by members of the American Bar Association Subcommittee on the 1933 Act raises questions as to the advisability of using as the statutory basis for Proposed Rule 240, §3(b) of the 1933 Act: reliance on §3(b) rather than on §4(2) may (a) support the inference that an exemption under § 4(2) of the 1933 Act for a small offering is available only if all offerees are sophisticated and able to fend for themselves; (b) it raises a variety of other problems in integration of present rules and doctrines under §3(b). Letter of Carl Schneider and Melvin Katz to Securities and Exchange Commission dated October 4, 1974.

Clauses (h) and (i) are not part of the ALI Code solution but rather an attempt to maintain present SEC traditions as set forth in the various regulations under § 3(b), such as Regulation A, Rule 227, and proposed Rule 240.

We would further propose on issues not exceeding $100,000, provided that no sales commissions were paid, that the filing of the notice with the SEC be eliminated and if there were ten or less purchasers, the offering circular requirement be eliminated.

If a proposal such as this were adopted, then perhaps we might then fulfill the original characterization of the Act that was contained in the House Report which stated that the Act "carefully exempts from its application certain types of securities and security transactions where there is not practical need for its application or where the public benefits are too remote."

APPENDIX

RULE 146

(a) *Definitions.* The following definitions shall apply for purposes of this rule.

(1) *Offeree Representative.* The term "offeree representative" shall mean any person or persons, each of whom the issuer and any person acting on its behalf, after making reasonable inquiry, have reasonable grounds to believe and believe satisfies all of the following conditions:

(i) is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the offeree is:

(*a*) related to such person by blood, marriage or adoption, no more remotely than as first cousin;

(*b*) any trust or estate in which such person or any persons related to him as specified in subdivision (*a*) or (*c*) collectively have 100 percent of the beneficial interest (excluding contingent interests) or of which any such person serves as trustee, executor, or in any similar capacity; or

(*c*) any corporation or other organization in which such person or any persons related to him as specified in subdivision (a) or (*b*) collectively are the beneficial owners of 100 percent of the equity securities (excluding directors' qualifying shares) or equity interest;

(ii) has such knowledge and experience in financial and business matters that he, either alone, or together with other offeree representatives or the offeree, is capable of evaluating the merits and risks of the prospective investment;

(iii) is acknowledged by the offeree, in writing, during the course of the transaction, to be his offeree representative in connection with evaluating the merits and risks of the prospective investment; and

(iv) discloses to the offeree, in writing, prior to the acknowledgement specified in subdivision (iii), any material relationship between such person or its affiliates and the issuer or its affiliates, which then exists or is mutually understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

NOTE 1: Persons acting as offeree representatives should consider the applicability of the registration and anti-fraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 and relating to investment advisers under the Investment Advisers Act of 1940.

NOTE 2: The acknowledgment required by subdivision (iii) and the disclosure required by subdivision (iv) must be made with specific reference to each prospective investment. Advance blanket acknowledgment, such as for "all securities transactions" or "all private placements," is not sufficient.

NOTE 3: Disclosure of any material relationships between the offeree representative or its affiliates and the issuer or its affiliates does not relieve the offeree representative of its obligation to act in the interest of the offeree.

(2) *Issuer.* The definition of the term "issuer" in Section 2(4) of the Act shall apply, provided that notwithstanding that definition, in the case of a proceeding under the Bankruptcy Act, the trustee, receiver, or debtor in possession shall be deemed to be the issuer in an offering for purposes of a plan of reorganization or arrangement, if the securities offered are to be issued pursuant to the plan, whether or not other like securities are offered under the plan exchange for securities of, or claims against, the debtor.

(3) *Affiliate.* The term "affiliate" of a person means a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with such person.

(4) *Material.* The term "material" when used to modify "relationship" means any relationship that a reasonable investor might consider important in the making of the decision whether to acknowledge a person as his offeree representative.

(b) *Conditions to be Met.* Transactions by an issuer involving the offer, offer to sell, offer for sale or sale of securities of the issuer that are part of an offering that is made in accordance with all the conditions of this rule shall be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act.

(1) For purposes of this rule only, an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act of pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, *provided*, that there are during neither of said six month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

NOTE: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to the rule, *see* Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale or sales may be deemed to be part of the offering.

(c) *Limitations on Manner of Offering.* Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio;

(2) Any seminar or meeting, *except* that if subparagraph (d)(1) is satisfied as to each person invited to or attending such seminar or meeting, and, as to persons qualifying only under subdivision (d)(1)(ii), such persons are accompanied by their offeree representative(s), then such seminar or meeting shall be deemed not to be a form of general solicitation or general advertising; and

(3) Any letter, circular, notice or other written communication, *except* that if subparagraph (d)(1) is satisfied as to each person to whom the communication is directed and the communication contains an undertaking to provide the information specified by subparagraph (e)(1) on request, such communication shall be deemed not to be a form of general solicitation or general advertising.

(d) *Nature of Offerees.* The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:

(1) immediately prior to making any offer, either:

(i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) that the offeree is a person who is able to bear the economic risk of the investment

; and

(2) immediately prior to making any sale, after making reasonable inquiry, either:

(i) that the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) that the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

(e) *Access to or Furnishing of Information.*

NOTE: Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment.

(1) Either

(i) each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or

(ii) each offeree or his offeree representative(s), or both, shall have been furnished during the course of the transaction and prior to sale, by the issuer or any person acting on its behalf, the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. This condition shall be deemed to be satisfied as to an offeree if the offeree or his offeree representative is furnished with information, either in the form of documents actually filed with the Commission or otherwise, as follows:

(*a*) in the case of an issuer that is subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934:

(*1*) the information contained in the annual report required to be filed under the Exchange Act or a registration statement on Form S-1 under the Act or on Form 10 under the Exchange Act, whichever filing is the most recent required to be filed, and the information contained in any definitive proxy statement required to be filed pursuant to Section 14 of the Exchange Act and in any reports or documents required to be filed by the issuer pursuant to Section 13(a) or 15(d) of the Exchange Act, since the filing of such annual report or registration statement, and

(*2*) a brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs which are not disclosed in the documents furnished;

(*b*) in the case of all other issuers, the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use, *provided*, however, that if the issuer does not have the audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, such financial statements may be provided on an unaudited basis;

(*c*) notwithstanding subdivision (e)(1)(ii)(*a*) and (*b*) exhibits required to be filed with the Commisson as part of a registration statement or report need not be furnished to each offeree or offeree representative if the contents of the exhibits are identified and such exhibits are available pursuant to subparagraph (e)(2)
; and

(2) The issuer shall make available, during the course of the transaction and prior to sale, to each offeree or his offeree representative(s) or both, the opportunity to ask questions of, and receive answers from, the issuer or any person acting on its behalf concerning the terms and conditions of the offering and to obtain any additional information, to the extent the issuer possesses such information or can acquire it without unreasonable effort or expense, necessary to verify the accuracy of the information obtained pursuant to subparagraph (e)(1) above; and

(3) The issuer or any person acting on its behalf shall disclose to each offeree, in writing, prior to sale:

(i) any material relationship between his offeree representative(s) or its affiliates and the issuer or its affiliates, which then exists or mutually is understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship;

(ii) that a purchaser of the securities must bear the economic risk of the investment for an indefinite period of time because the securities have not been registered under the Act and, therefore, cannot be sold unless they are subsequently registered under the Act or an exemption from such registration is available; and

(iii) the limitations on disposition of the securities set forth in subparagraphs (h)(2), (h)(3), and (h)(4) of the rule.

NOTE: Information need not be provided and opportunity to obtain additional information need not be continued to be provided to any offeree or offeree representative who, during the course of the transaction, indicates that he is not interested in purchasing the securities offered, or, except in the case of any undertaking made pursuant to subparagraph (c)(3), to whom the issuer or any person acting on its behalf has determined not to sell the securities.

(f) *Business Combinations.*

(1) The term "business combination" shall mean any transaction of the type specified in paragraph (a) of Rule 145 under the Act.

(2) All the conditions of this rule except paragraph (d) and subparagraph (h)(4) shall apply to business combinations.

NOTE: Notwithstanding the absence of a written agreement pursuant to subparagraph (h)(4), any securities acquired in an offering pursuant to paragraph (f) are restricted and may not be resold without registration under the Act or an exemption therefrom.

(3) For purposes of paragraph (f) only, the issuer and any person acting on its behalf, after making reasonable inquiry, shall have reasonable grounds to believe, and shall believe, at the time that any plan for a business combination is submitted to security holders for their approval, that each offeree either alone or with his offeree representative(s) has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and risks of the prospective investment.

(4) In addition to information required by paragraph (e), the issuer shall provide, in writing, to each offeree at the time the plan is submitted to security holders for approval, information about any terms or arrangements of the proposed transaction relating to any security holder that are not identical to those relating to all other security holders.

(g) *Number of Purchasers.*

(1) There shall be no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the rule.

NOTE: See subparagraph (b)(1), the note thereto and the Preliminary Notes as to what may or may not constitute an offering pursuant to the rule.

(2) For purposes of computing the number of purchasers for subparagraph (g)(1) only:

(i) the following purchasers shall be excluded:

(*a*) any relative or spouse of a purchaser and any relative of such spouse, who has the same home as such purchaser; and

(*b*) any trust or estate in which a purchaser or any of the persons related to him as specified in subdivision (g)(2)(i)(*a*) or (*c*) collectively have 100 percent of the beneficial interest (excluding contingent interests);

(*c*) any corporation or other organization of which a purchaser or any of the persons related to him as specified in subdivision (g)(2)(i)(*a*) or (*b*) collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interest; and

(*d*) any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.

NOTE: The issuer would have to satisfy all the other provisions of the rule with respect to the purchasers specified in subdivision (g)(2)(i).

(ii) There shall be counted as one purchaser any corporation, partnership, association, joint stock company, trust or unincorporated organization, *except* that if such entity was organized for the specific purpose of acquiring the securities offered, each beneficial owner of equity interests or equity securities in such entity shall count as a separate purchaser.

NOTE: See Preliminary Note 5 as to other persons who are considered to be purchasers.

(h) *Limitations on Disposition.* The issuer and any person acting on its behalf shall exercise reasonable care to assure that the purchasers of the securities in the offering are not underwriters within the meaning of Section 2(11) of the Act. Such reasonable care shall include, but not necessarily be limited to, the following:

(1) making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;

(2) placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;

(3) issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

(4) obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom.

NOTE: Subparagraph (h)(4) does not apply to business combinations as described in paragraph (f). Notwithstanding the absence of a written agreement, the securities are restricted and may not be resold without registration under the Act or an exemption therefrom. The issuer for its own protection should consider, however, obtaining such written agreement even in business combinations.